SET-OFF IN CASES OF IMMATURE CLAIMS IN INSOLVENCY AND RECEIVERSHIP

INTRODUCTION

WHEN insolvency takes place and an assignee or equitable receiver takes charge of the assets of the insolvent, settles and adjusts claims and distributes the assets to creditors and those entitled to receive them, the matter of set-off frequently presents some difficulties. When a creditor owes the insolvent payable *in futuro*, and the insolvent owes such creditor payable *in presenti*, the American authorities almost without exception allow a set-off.[1] When a creditor owes the insolvent and the insolvent owes the creditor *in futuro*, many American cases refuse to allow such creditors a set-off.[2] Some cases, however, do under such circumstances allow a set-off.[3] However, since in certain cases, of insolvency and bankruptcy a natural equity demands the set-off of present obligations, even though payable *in futuro*,[4] it is difficult to conceive that the principles or the usages and rules of equity devised for securing justice and equity should raise up barriers to the working out of this natural equity. And it is difficult to see how the American

[1] Lindsay *v.* Jackson, 2 Paige (N. Y.) 581 (1831); Bradley *v.* Angel, 3 N. Y. 475 (1850); Smith *v.* Felton, 43 N. Y. 419 (1871); Hughitt *v.* Hayes, 136 N. Y. 163, 32 N. E. 706 (1892); Fera *v.* Wickham, 135 N. Y. 223, 31 N. E. 1028 (1892); Scott *v.* Armstrong, 146 U. S. 499 (1892); Yardley *v.* Clothier, 51 Fed. 506 (1892).

[2] Lindsay *v.* Jackson, 2 Paige (N. Y.) 581 (1831) (*obiter*); Spaulding *v.* Backus, 122 Mass. 553 (1877); Hannon *v.* Williams, 34 N. J. Eq. 255 (1881); Fera *v.* Wickham, 135 N. Y. 223, 31 N. E. 1028 (1892); Dunn *v.* Uvalde Asphalt Paving Co., 175 N. Y. 214, 219, 67 N. E. 439 (1903); Groff *v.* Friedline, 14 N. Y. Misc. 23, 35 N. Y. Supp. 755 (1895); Chipman *v.* Ninth Nat. Bank, 120 Pa. St. 76, 13 Atl. 707 (1888); Homer *v.* Nat. Bank, 140 Mo. 225, 41 S. W. 790 (1897); Taylor *v.* Weir, 63 Ill. App. 82 (1895); Ellis *v.* First National Bank, 22 R. I. 565, 48 Atl. 936 (1901). (Statute involved.)

[3] Kentucky F. Co., Assignee *v.* Mer. Nat. Bank, 90 Ky. 225, 13 S. W. 910 (1890); Nashville Trust Co. *v.* Bank, 91 Tenn. 336, 18 S. W. 822 (1891); Georgia Seed Co. *v.* Talmadge, 96 Ga. 254, 22 S. E. 1001 (1895); Ainsworth *v.* Bank of Cal., 119 Cal. 470, 51 Pac. 952 (1897); Thomas *v.* Exchange Bank, 99 Iowa 202, 68 N. W. 780 (1896); Colton *v.* Drovers Bldg. Assn., 90 Md. 85, 45 Atl. 23 (1899); Richardson *v.* Anderson, 109 Md. 641, 72 Atl. 485 (1909); Hayden *v.* Citizens Nat. Bank, 120 Md. 163, 87 Atl. 672 (1913); Brown *v.* Sheldon State Bank, 139 Iowa 83, 117 N. W. 289 (1908).

[4] Lord Mansfield in Greene *v.* Farmer, 4 J. Burr. 2214 (1768).

cases can consistently allow a set-off to a creditor whose present claim is payable the day insolvency is declared and refuse to allow a set-off to a creditor whose present claim against the insolvent is payable a day after insolvency is declared. There must be some way of working out this natural equity just referred to without offending any equitable principles or any of the usages and rules of equity. It is our purpose in this article to analyze the contradictory decisions on the subject of equitable set-off in cases of insolvency declared and receiver appointed, and try to reach an understanding of the underlying principles involved.

At common law no set-off existed,[5] because simplicity and rigidity of procedure militated against any variation or adjustment of plaintiff's claim against defendant. The first statutes providing for a set-off at common law were enacted without specific reference to solvency or insolvency, and as a matter of convenience. Courts of equity have from an early date recognized the right of set-off.[6] They did so before common law statutes of set-off were passed, and before the bankruptcy statutes of set-off existed. The first bankruptcy statutes allowing a set-off were passed, because as Lord Mansfield said, natural justice and equity demand that in certain cases when insolvency and bankruptcy take place, cross demands should compensate each other by deducting the less sum from the greater, and the difference is the only sum which is justly due.[7] Courts of equity have generally followed courts of law in their construction of set-off statutes.[8] They have rarely, if ever, broken in upon the decisions of law unless some other equity intervened, which justified them in granting relief beyond the rules of law. This has been true in England, and the American courts have generally adopted the same principles in so far as the statutes of set-off of the respective states have enabled them to act.[9]

An equitable set-off is a remedial right, in that, if successfully pleaded, it is a bar to a recovery either *in toto* or *pro tanto*.[10] How-

[5] Central Appalachian Co. *v.* Buchanan, 90 Fed. 454, 459 (1898); Lord Mansfield in Greene *v.* Farmer, 4 J. Burr. 2214 (1768).

[6] Greene *v.* Farmer, 4 J. Burr. 2214 (1768); *Ex parte* Stephens, 11 Vesey 24 (1805); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454, 459 (1898).

[7] Lord Mansfield in Greene *v.* Farmer, 4 J. Burr. 2214 (1768).

[8] Greene *v.* Darling, 5 Mason (U. S.) 201, 212 (1828); Howe *v.* Sheppard, 2 Sumner (U. S.) 409, 412 (1836).

[9] Greene *v.* Darling, 5 Mason (U. S.) 201, 212 (1828).

[10] Sovereign Life Insurance Co. *v.* Dodd [1892], 2 Q. B. 573, 578.

ever, every remedial right must be based or granted on a showing of some substantive right by one who demands the remedial right. As between solvent parties, the allowance or disallowance of a set-off is largely a matter of convenience; as between a solvent and an insolvent party, or the estate of an insolvent, it is more than a matter of convenience, because the rights of various creditors become involved. If a claimant has a lien, charge or equity against certain of the insolvent's property before insolvency, the act of insolvency or the death [11] or the assignment or receivership cannot change these substantive rights.[12] If a claimant has a substantive right or claim against the insolvent himself before insolvency or assignment or receivership, with few exceptions of a personal nature, these substantive rights cannot be divested by insolvency or assignment or receivership or death. A court of equity cannot change the contracts and rights of a claimant which existed before insolvency declared; it cannot take these away nor add to them,[13] nevertheless, the act of insolvency resulting in a breach of contract to pay either presently or in the future, may be the occasion for a court of equity to apply the remedial right of set-off based on an implied contract.[14] The court overcomes the shortsightedness of individuals by finding a contract to set-off when the transactions are such between them as would justify the court in so doing.

The theory of equitable set-off may be said to have been adopted from the civil law.[15] Under the civil law there existed what was called "compensation." When two cross demands of a nature substantially the same and due from A to B, existed in the same right, that is to say, when the one was a creditor in his own right and a debtor also in his own right to the other, then according to the civil law the debts were deemed *suo jure* set-off or extinguished *pro tanto*. Equity follows the civil law to a certain extent, but gives the party

[11] Ainsworth *v.* Bank, 119 Cal. 470, 51 Pac. 952 (1897); Schwarz *v.* Harris, 206 Fed. 936, 939 (1913); Traders Nat. Bank *v.* Cresson, 75 Tex. 298, 12 S. W. 819 (1889); Ford Admr. *v.* Thornton, 3 Leigh (Va.) 695 (1832).

[12] *In re* Receivership Lord & Polk Chemical Co., 7 Del. Ch. 248 (1895); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898); Johnson *v.* Garner, 233 Fed. 756 (1916).

[13] Quincy, etc. Ry. *v.* Humphries, 145 U. S. 82 (1892); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898).

[14] See subject of Implied Contracts discussed in 1 WILLISTON ON CONTRACTS, § 3. See also note 35, *infra*.

[15] Duncan *v.* Lyon, 3 John. Ch. (N. Y.) 351, 357 (1818).

from whom payment is demanded the right of set-off in the proper case if he chooses to exercise it, but if he does not, the debt is left in full force to be recovered in an adversary suit.[16] The substantive right of set-off may be created by express contract, in which case it must be recognized by a court of law and by a court of equity. If A owes B and B owes A, and they expressly agree that neither at any time of settlement shall have a claim against the other for a sum or amount greater than a balance struck between them, then if one sues the other, the amount of his actionable claim is in equity only a balance struck as agreed. On the other hand, if no express agreement as to set-off exists between A and B, yet when the circumstances and the dealings between A and B are presented to the court, the court finds that it can imply a contract between them that each shall have a claim against the other at any time for only a balance struck, then we have a basis for an equitable set-off even though no express contract of set-off between the parties has been shown.[17]

An apparent difficulty, however, arises when it is discovered that although the claims or debts on either side are present obligations, nevertheless, one or both of these present obligations may be payable *in futuro*. Our contention is that if a court of equity can find an implied contract between the insolvent and the creditor or debtor to set off their respective obligations, one against the other, from time to time, then the fact that one or the other of these present obligations may be payable *in futuro* does not in case of insolvency and anticipatory breach of contract prevent a set-off. In cases where the creditor owes the insolvent *in futuro* the question must present itself as follows: Has the creditor entered into a present obligation owing *in futuro* with the understanding and on the faith and expectation that any advances that he may make to the other party although not in the direct form of payment of this future payable obligation, shall be credited as part payment on his future obligation? When we say advances to be credited as payments on the future payable obligation, we include of course, any obligation running in favor of the party who credits the same. In other

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16 Greene *v.* Darling, 5 Mason (U. S.) 201, 212 (1828).

17 *In re* Receivers of the Globe Ins. Co., 2 Ed. Ch. (N. Y.) 625 (1836); Greene *v.* Darling, 5 Mason (U. S.) 201, 215 (1828); Carr *v.* Hamilton, 129 U. S. 252, 262 (1888); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898).

words, if A owes B subsequently, and B owes A presently, then in case of insolvency of B the circumstances of their transactions may authorize the court to imply a contract entitling A to apply toward the payment of his obligation any advances he makes to B, or any obligations B incurs in favor of A.

However, if A owes B presently, and B owes A subsequently, in case of the insolvency of B the court may also find an implied contract entitling A to apply towards the payment of his claim any advances he makes to B or any obligations B creates in favor of A. Before insolvency and breach of contract on the part of B, A's claim was due and payable *in futuro*, but the anticipatory breach by B has created a present right and claim in A which has a measurable value and should be set off to the extent of this value against what A owes presently. If there has been an anticipatory breach, does the holder of such an obligation against the insolvent have to wait until the maturity of his obligation to present his claim or bring suit against the insolvent or his estate any more than he would have to wait until a time subsequent to an anticipatory breach of any other contract entered into and breached? If the obligation entered into by the insolvent has been breached, the holder of such an obligation is entitled to compensation against the party breaching the contract. In the case of a life insurance policy contract breached by the insurer before maturity, the value of this policy at the time of breaching is the measure of the policy holder's compensation.[18] The value of a contract to pay money at a future time is easily measured if no interest is agreed upon, and if interest is agreed upon, the measure is the face of the claim plus the interest up to date on the contract, or a rebate of interest, if interest has been paid in advance.[19] The fallacy which those courts make which refuse to allow a set-off to a creditor who has a claim against the insolvent payable *in futuro*, lies, we believe, in their failure to recognize a measurable obligation owing from the insolvent at the time of his insolvency, and also an implied contract to set off this obligation.

Of course, difficulties arise as to what transactions between the parties and what course of dealings will justify a court of equity in finding an implied contract of set-off between the parties. The best light we can get on this subject is to refer to the English bank-

[18] *In re* Albert Life Assn. Company, L. R. 9 Eq., 706, 716 (1870).

[19] Thomas *v.* Western Car Co., 149 U. S. 95, 117 (1893).

ruptcy statutes covering a set-off. If the bankruptcy statutes were founded on natural justice and equity, as stated by Lord Mansfield, we may look to such statutes and follow their development to determine what is natural justice and equity in the matter of a set-off in cases of insolvency followed by a present or future repudiation of debts and final distribution of the estate. The English bankruptcy statute, on the subject of set-off, started out by allowing mutual debts to be set off. The words "mutual debts," it was found, did not cover certain transactions between the parties which natural justice and equity dictated should be the subject of a set-off. Wherefore, later on, the word "credits" was added. The words "mutual debts and credits" were intended to comprise all ordinary transactions between two persons in their individual capacities. Later on, it was thought that the words "mutual debts and credits" were not broad enough to cover all cases justifying a set-off, whereupon the statute was changed to read "mutual debts, credits and mutual dealings." The words "mutual dealings" were added to get rid of any questions which might arise whether a transaction would end in a debt or not. The additional words "mutual dealings" were intended to give a more extended right of set-off than previously existed.[20] As indicating the belief of the English Parliament that the same rights of set-off allowed in bankruptcy proceedings should be allowed in insolvency proceedings and in winding up of corporations, the English Judicature Act of 1873 and 1875, by Section 10, specifically provided that in such cases the right of set-off as allowed and provided for in cases of bankruptcy should avail.

Our American bankruptcy act uses the words "mutual debts" or "mutual credits." Although courts of equity in the United States are not bound by the English bankruptcy statutes, or even the American bankruptcy statutes on the subject of set-offs, nevertheless, courts of equity may find a great deal of light on the subject of equitable set-off by investigating the questions of set-off as worked out by the English and American bankruptcy acts and by the decisions under those acts.

The fact that the set-off claimed is based on a legal right of action does not in most jurisdictions prevent its being set up as a

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[20] Booth *v.* Hutchinson, L. R. 15 Eq. 30 (1872).

defense either to a suit at law or an action in equity.[21] The Civil Codes of the several states generally abolish the formal distinctions between suits at law and actions in equity and permit all defenses, counterclaims and set-offs, whether formerly known as legal or equitable. The courts of the United States now by statute permit an equitable defense to be interposed by answer, plea or replication to a legal action,[22] and Equity Rule No. 30 permits a legal or equitable claim to be set up in answer to an action in equity. The fact that the claim of set-off may be unliquidated, is no objection in a court of equity to allowing it as a set-off.[23]

Coming to the question of whether or not mere insolvency will be sufficient to authorize a court to allow an equitable set-off, a number of authorities, including the Supreme Court of the United States, hold that insolvency of the party against whom the set-off is claimed, is a sufficient ground for equitable interference and the allowance of a set-off.[24] The courts of Massachusetts, however, hold that insolvency unaccompanied by a formal adjudication of the debtor's insolvency, or bankruptcy, or making of an assignment for the benefit of creditors, is not sufficient to authorize a court of equity to allow an equitable set-off in the case of a debt payable in the future by the insolvent.[25] Our understanding of the situation is, that it is the anticipatory breach of his contract to pay by the insolvent which authorizes a court of equity to apply the equitable remedy of set-off, and insolvency except in a few cases always is a present or anticipatory breach of a contract. It is inequitable for the insolvent to breach his contract to pay in the future and at the same time demand that the other party to the transaction comply with his contract and pay over presently to the insolvent or to the insolvent's estate money or property.[26] We believe the United States Courts, when they say insolvency is a sufficient ground for equitable interference, must use the word in the sense that insolvency means a breach of contract to pay debts both present and

[21] Stone *v.* Fargo *et al.* 55 Ill. 71 (1870); Scott *v.* Armstrong, 146 U. S. 499 (1892); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898).

[22] Act of March 3, 1915, c. 90, 38 STAT. AT L. 956.

[23] Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898).

[24] Rolling Mill Co. *v.* Ore and Steel Co., 152 U. S. 596 (1894).

[25] Spaulding *v.* Backus, 122 Mass. 553 (1877); Wiley *v.* Bunker Hill Nat. Bank, 183 Mass. 495, 67 N. E. 655 (1903); Jump *v.* Leon, 192 Mass. 511, 78 N. E. 532 (1906).

[26] Nashville Trust Co. *v.* Bank, 91 Tenn. 336, 18 S. W. 822 (1892).

future. On the other hand, when the Massachusetts courts restrict the term "insolvency" to mean insolvency or bankruptcy proceedings, or assignment for the benefit of creditors, they are restricting the term too much. Insolvency proceedings, bankruptcy and assignment for the benefit of creditors, may be evidence of a breach of contract to pay on the part of the insolvent; nevertheless, there may be insolvency and breach of contract to pay in other cases not covered by the above proceedings. If the insolvent is a corporation and is dissolved and all its assets are distributed, it certainly is impossible for the corporation to pay obligations which are payable *in futuro*.[27] The same thing holds true when the estate of a deceased is declared to be insolvent.[28] In the case of the estate of an insolvent individual or partnership, of course, the making of an assignment and the appointment of receiver does not necessarily put it out of the power of the insolvent to acquire property subsequently and pay an obligation when it becomes due. It therefore becomes the duty of the court distributing the assets to determine whether or not there has been an anticipatory breach of an executory contract, and whether a right of set-off accrues to the other party by reason of the breach by the insolvent party.

SET-OFF WHEN CLAIM OF INSOLVENT NOT DUE

In the United States the cases almost without exception hold that a debtor to the insolvent's estate whose debt is a present obligation but is not due and payable at time of insolvency declared, can set off as against this debt a claim of the insolvent against this debtor, when the insolvent's claim is due and payable at time of insolvency declared.[29] The reason generally given is, that equity will compel a set-off in such a case on the theory that the creditor to the insolvent, or to the insolvent's estate, is entitled to waive time of payment and to have the assignee or receiver restrained from holding such a claim as an investment, or from disposing of the same and distributing the proceeds among the general creditors.

The leading case on the subject is *Lindsay* v. *Jackson*,[30] wherein

[27] Pennsylvania Steel Co. *v.* New York City Ry. Co., 198 Fed. 721, 743 (1912).

[28] Ford *v.* Thornton, 3 Leigh (Va.) 695, 698 (1832); Camden Nat. Bank *v.* Green (18 Stew.) 45 N. J. Eq. 546, 17 Atl. 689 (1889).

[29] See note 1, *supra*.

[30] 2 Paige (N. Y.) 581 (1831).

the complainants on or about May 1831, gave to the defendants two negotiable promissory notes for $1500 each, payable six months from date without interest; and the defendants about the same time became indebted to the complainants on an acceptance, payable in June 1831. A few days before this acceptance became due the defendants became insolvent and stopped payment, but no assignment was made, neither was any receiver appointed. In July of the same year, the complainants filed their bill in equity to restrain the defendants from negotiating or transferring notes, and prayed that the amount to become due be set off or applied in part satisfaction of the money due on the acceptance. The trial court allowed an injunction as prayed for. Chancellor Walworth refused to dissolve the injunction on appeal, saying among other things, as follows:

"As the notes are not on interest, there can be no injustice in compensating the defendants for the amount to become due thereon at a future day by a present payment. The complainants alone had any interest in obtaining the time of credit which was given on these demands. It might present an entirely different question if the defendants' debt was now due from the complainants, who were seeking to compensate it by a claim against the defendants, payable at a future day. . . . Here, the defendants could not claim present payment of their notes, due six months hence, and therefore it would be inequitable for them, by an off-set, to compel the complainants to pay those notes before they became due. But as the debt of the defendants is due, and if they paid it immediately, according to their agreement, the complainants might, without any injustice to the other party, waive the time of credit which was for their own benefit, and pay the notes immediately with the money thus received, the defendants have no cause to complain of such a mode of compensating one debt by another." [31]

In the case of *Lindsay* v. *Jackson*, the justification of the Chancellor in restraining the defendants from disposing of the notes, seems to rest on the fact that without such a restraint the notes might get into the hands of innocent purchasers for value without notice, and therefore the makers of the notes be unjustly deprived of their defense of set-off. Such a restraining order may have been necessary in *Lindsay* v. *Jackson*, because there is no showing that an assignment had been made or receiver appointed. If such had been

[31] 2 Paige (N. Y.), 584–585.

the case, the injunction might not have been necessary, because an assignee or receiver does not take as innocent purchaser for value without notice, but any infirmities or defenses good against an assignor of a negotiable instrument must be good as against such assignee or receiver, and any purchaser from any assignee or receiver cannot very well take without notice.[32] As for the statement made by Chancellor Walworth that the plaintiffs may waive the time of credit, this statement appears to us to be in conflict with the fundamental principles and usages and rules of equity that the court appointing the receiver cannot change or alter the contract between the parties, and if the court cannot do this, neither a creditor or debtor of the insolvent can do it, nor can the assignee or receiver do it. The making of an assignment or the appointment of a receiver does not take away any substantive contractual rights which belonged either to the insolvent, or to the creditor, or debtor of the insolvent, previous to insolvency declared. If, before insolvency, the debtor has no right to pay his obligations at once against the insolvent's wishes nor to restrain the insolvent from disposing of his investment by sale or otherwise, it follows that after insolvency the debtor has no contractual right to pay the assignee or receiver ahead of time nor to restrain him from disposing of the claim or investment by sale or otherwise,[33] unless such obligation or negotiable security is about to be transferred in such a way as to cut off the maker's defense of set-off or other meritorious defense.[34]

If, however, Chancellor Walworth could have found an express or implied contract between the complainant and the defendant to the effect that the obligations entered into by the complainants, payable in the future, were made with the faith and understanding that any advances or indebtedness running to the complainants from the insolvent were by an implied agreement to be from time to time or on demand credited *pro tanto* on the complainant's indebtedness, and such indebtedness be reduced accordingly, then the court could have allowed the set-off without resorting to the waiver theory, and without forcing a change or alteration of the

[32] Smith *v.* Felton, 43 N. Y. 419, 423 (1871).

[33] *In re* Commercial Bank Corporation of India and the East, L. R. 1 Ch. 538, 543 (1866).

[34] Rolling Mill Co. *v.* Ore and Steel Co., 152 U. S. 596, 615 (1894); Schwarz *v.* Harris, 206 Fed. 936, 939 (1913); Central Appalachian Co. *v.* Buchanan, 90 Fed. 454 (1898).

contract between the parties.[35] Chancellor Walworth, besides deciding the case before him, says as follows:

"It might present an entirely different question if the defendants' debt was now due from the complainants, who were seeking to compensate it by a claim against the defendants, payable at a future day." [36]

These remarks just quoted were *obiter dictum*, but nevertheless they seem to have been grasped by future courts as an authority for refusing to allow a set-off in an otherwise proper case wherein a present debt owed by the insolvent was due and payable subsequent to the time when the assignee or receiver was appointed.

The case of *Bradley* v. *Angel* [37] follows with approval *Lindsay* v. *Jackson*, and allows a set-off to a creditor who owes the insolvent an obligation payable *in futuro*. This case is subsequently followed in 1892 by *Hughitt* v. *Hayes*.[38] The leading case in the Supreme Court in the United States on this subject is *Scott* v. *Armstrong*.[39] In this latter case the note admitted to be set off did not mature until subsequent to the receivership of a National Bank. A claim against the deposit in the National Bank was due and payable at time of receivership. Chief Justice Fuller allowed the holder of a

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[35] Said Chief Justice Fuller:

"Indeed natural justice would seem to require that where the transaction is such as to raise the presumption of an agreement for a set-off it should be held that the equity that this should be done is superior to any subsequent equity not arising out of a purchase for value without notice."

Armstrong *v.* Scott, 146 U. S. 499, 508 (1892).

Said Parker, C. J.:

"It is quite common for those who have given negotiable securities to make advances to their creditors on the faith and expectation of an allowance and adjustment, although not in the direct form of payment of their notes. Death or insolvency of the payee often occurs, and manifest injustice is done if the party so advancing is to be treated as a debtor to the whole amount, and as a creditor for what he may have so advanced. If his note is transferred while unimpeached, it is but right that he should suffer, for he has promised every *bona fide* holder according to the face of the note. But he who takes it with notice of grounds of defense, or after it is due, which the law charges as notice, is holden to take it altogether on the credit of the indorser, knowing, or being presumed to know, that if the promisor had any dealings with the payee which would justify a defense, the note is chargeable with that defense in his hands."

Sargent *v.* Southgate, 22 Mass. (5 Pick.) 312, 317 (1827).

[36] 2 Paige (N. Y.) 581, 585 (1831).

[37] 3 N. Y. 475 (1850).

[38] 136 N. Y. 163, 32 N. E. 706 (1892).

[39] 146 U. S. 499 (1892).

claim against the bank as depositor to set off this claim against his note which was payable at the bank subsequently. The court said among other things, as follows:

> "It was, therefore, the balance upon the adjustment of the accounts which was the debt, and the Farmers' Bank [creditor asking for a set-off] had the right, as against the receiver of the Fidelity Bank, although the note matured after the suspension of that bank, to set off the balance due on its deposit account, unless the provisions of the national banking law were to the contrary." [40]

Chief Justice Fuller's language seems to be broad enough to cover a debt due from the insolvent after insolvency declared, provided the transactions between the parties were entered into with the faith and understanding that advances should be credited on future payable obligations. At least, Chief Justice Fuller does not deny such to be the case. Furthermore, he puts his decision on the theory of an implied contract between the parties, and not on the theory of waiver as had the New York case, saying,

> "Indeed natural justice would seem to require that where the transaction is such as to raise the presumption of an agreement for a set-off it should be held that the equity that this should be done is superior to any subsequent equity not arising out of a purchase for value without notice." [41]

The true test of allowing a set-off in cases of present obligations of a creditor, payable *in futuro*, seems to us to be this: Can the court find an implied contract between the insolvent and a creditor that the present obligation of the creditor payable in the future was entered into on the faith and understanding and expectation that any advances made by the creditor, or any considerations flowing from the creditor, resulting in obligations of the insolvent were made or allowed on the faith and understanding and expectation that they should be considered by the insolvent as an allowance and adjustment, although not in the direct form of payment of the present obligation payable in the future? If the obligation is a non-negotiable one it passes to a transferee encumbered with the right of set-off. If a negotiable note is transferred to one having notice of the right of set-off, or held to have notice, then the note is chargeable

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[40] 146 U. S. 508.

[41] *Ibid.*, 508.

with the defense of set-off in the hands of the transferee.[42] The situation of the parties is as follows:

A owes B subsequently
B owes A presently
B becomes insolvent

The court finds that it is the express or implied understanding between A and B that any advances made by A or any obligations running from B to A shall be considered as and credited on the obligation of A to B and reduce it *pro tanto*. It is difficult to conceive why such advances should be credited against a present obligation payable presently and not against a present obligation payable *in futuro*. If the court can imply an understanding and contract as stated above, we believe a set-off should be allowed. If on the other hand the transactions between the parties positively oppose such an understanding, then no set-off can be created by a court of equity any more than it can itself create any other contractual right.

SET-OFF WHEN CLAIM AGAINST INSOLVENT IS NOT DUE

What are the rights of set-off belonging to a claimant who owes the insolvent presently due when the obligation of the insolvent is absolute but not due and payable at time when insolvency is declared? [43]

One of the first cases of great importance on the subject in the United States is *Spaulding* v. *Backus*,[44] wherein the court, speaking on the subject of set-off of immature claims, says;

"For, assuming that a court of equity may enforce a set-off in favor of a plaintiff, to whom a debt is due, against an insolvent debtor, who holds a claim not due, it by no means follows that it would be equitable to protect a plaintiff from the payment of his debt according to his contract, simply because the defendant, against whom he has a claim due

[42] Sargent *v.* Southgate, 22 Mass. (5 Pick.) 312–318 (1827); Smith *v.* Felton, 43 N. Y. 419, 423 (1871); Chance *v.* Isaacs, 5 Paige (N. Y.) 592 (1836); Colton *v.* Drovers Bldg. Assn., 90 Md. 85, 45 Atl. 23 (1899).

[43] Cases refusing to allow a set-off. See note 2, *supra*. Cases allowing a set-off. See note 3, *supra*.

[44] See note 2, *supra*.

at a future day, is at the time insolvent. In the one case, an insolvent debtor, refusing to pay his own debt already due, would be simply restrained from holding a claim, not due against the plaintiff, as an investment, or for the purpose of paying or preferring creditors, and might be compelled to set it off, if the plaintiff were ready to anticipate payment. In the other, the plaintiff would be relieved from the performance of his contract presently due, and be allowed to obtain payment of his own claim before it is due by the terms of his contract." [45]

In reply to such a statement we may say that by allowing a set-off in either case, the court is allowing the creditor demanding the set-off to be paid otherwise than according to his contract and in preference to other creditors, unless the court can find an implied contract between the parties to the effect that neither party shall have a right to recover from the other party an amount in excess of a balance struck between them, covering their mutual debts, mutual credits or mutual dealings, and unless the declaration of insolvency has created an occasion for a set-off to be invoked and applied. When the court in *Spaulding* v. *Backus* says, that to allow a set-off when the plaintiff owes the insolvent a debt presently due as against a debt from the insolvent subsequently due, would be to relieve the plaintiff from his performance of his contract and to obtain payment before it is due, our answer is as follows: When the insolvent can no longer perform his contract to pay in the future, and by insolvency declares this to be the case, then the other party to the contract certainly is relieved of his agreement to wait for payment which will never take place, and has some rights when the repudiation is made. We cannot say correctly, that the maturity of the obligation is anticipated or hastened, because a court of equity cannot change the contract between the parties; but when the obligation is a present absolute one with the time of payment postponed, the anticipatory breach of the contract to pay must certainly give rise to a present claim for compensation and set-off if the dealings of the parties are not inconsistent with an implied contract to set off. However, what the court says in *Spaulding* v. *Backus* concerning a set-off of a debt of an insolvent payable in the future, is not applicable to all insolvent estates being administered, because *Spaulding* v. *Backus* involved a mere assignment of a chose in action and bankruptcy took place subsequently. Says the court, "Nor are the rules

[45] 122 Mass. 553, 557 (1877).

relating to the settlement of insolvent estates of persons living or deceased, or to actions brought by assignees under an assignment for the benefit of creditors to have application to the claim of an assignee of a chose in action."

In 1892 the Supreme Court of the State of New York decided the case of *Fera* v. *Wickham*,[46] which was the case of an assignment for the benefit of creditors. This was a case wherein the claim of the plaintiff against the insolvent had not matured at time of insolvency declared, but matured subsequently even before the demand held by the assignee had matured. In other words, before distribution was made, the claims to and from the insolvent had matured; yet the New York Court refused to allow a set-off, because at time of insolvency declared the claim against the insolvent had not matured. The New York Court says among other things:

"But after the estate has passed to an assignee upon a trust to hold for and to distribute among creditors, the former and natural equity disappears in superior equities vesting in the general body of creditors."

In other words, it is stated that the assignor by making an assignment has taken away natural equities, formerly existing in favor of one of his creditors. If an implied contract to set-off existed between the parties before assignment, then according to *Fera* v. *Wickham* this right of set-off is taken away by making the assignment, and the assignment itself gives the whole mass of creditors certain equitable rights which they did not have before. These propositions, although held in other cases in the state of New York,[47] are not in accord with the most recent rulings of the Circuit Court of Appeals [48] for the southern district of New York, nor with the most recent rulings of the Supreme Court of the United States.[49] *Fera* v. *Wickham* refers to the case of *Rothschild* v. *Mack*.[50] The Rothschild case allowed a set-off in favor of a claim against the insolvent due subsequent to assignment. The court in the Rothschild case held that the money was procured by the insolvent by fraud, and therefore, even though not in one sense due and payable

[46] See note 1, *supra*.

[47] See Author's Article on "Contingent and Immature Claims in Receivership Proceedings" 29 YALE L. J., 481, 488.

[48] Pennsylvania Steel Co. *v.* New York City Ry. Co., 198 Fed. 721, 743 (1912).

[49] William Filene's Sons Co. *v.* Weed, 245 U. S. 597, 602 (1918).

[50] 42 Hun (N. Y.) 72, affirmed 115 N. Y. 1, 21 N. E. 726 (1889).

at time of insolvency; nevertheless, an action of assumpsit arose at once in plaintiff's favor for the recovery back of the money. The law implied a promise to repay that amount. *Fera* v. *Wickham* refuses to follow the Rothschild case because fraud was not shown. The court said that in the Rothschild case an action of assumpsit existed at the time of insolvency. We say that in *Fera* v. *Wickham* and other cases where a breach of contract to pay in the future is found, that breach of contract creates a present right and an occasion for a court of equity to allow a set-off, provided the dealings between the parties are not inconsistent with such an implied contract to set off. If the Rothschild case is good law, we think that *Fera* v. *Wickham* should have been decided differently, and that a set-off should have been allowed therein.

A number of cases in the United States follow with approval the case of *Spaulding* v. *Backus* and *Fera* v. *Wickham*.[51] A number of cases, however, with or without citing *Fera* v. *Wickham*, hold that a debt from the insolvent payable subsequent to insolvency may be set off.[52] The court in the case of *Nashville Trust Company* v. *The Bank*[53] says:

> "Does it lie in the mouth of an insolvent to say that his contract is violated and thereby defeat so manifest an equity when it is apparent that he cannot himself perform that contract?"

When the court speaks of an equity, it must mean an equitable right to a set-off. The case of *Schuler* v. *Israel*[54] holds that a garnishee holding funds, and also holding a claim payable in the future and against the party garnisheed, will not be forced to give up these funds, but may hold them as a set-off.

IMMATURE CLAIMS HELD AND OWING BY BANKS

When insolvency is declared a bank may owe the insolvent presently on a general deposit account or a certificate of indebtedness or other claim and at the same time hold notes or other obligations against the insolvent which are payable *in futuro*. On the other hand, the bank may owe the insolvent on certificates of indebtedness or other obligations payable *in futuro* and hold notes or other obligations of the insolvent due and payable presently. It is

[51] See note 2, *supra*.

[52] See note 3, *supra*.

[53] See note 3, *supra*.

[54] 120 U. S. 506 (1887).

frequently said that a bank has a lien on all moneys and funds in its possession belonging to the depositor to secure any balance due the bank from such depositor.[55] Such a statement would indicate that a bank holds a superior position to an ordinary party under the same conditions. However, as between a bank and its general depositors, the bank occupies the relation of debtor to the depositor, and the depositor is a creditor of the bank. The funds of a general depositor in the bank are the property of a bank. A lien in equity practice is not equivalent to title to the property, it is neither a *jus in re* or a *jus ad rem.*[56] Although there may be possession of the thing by the lien holder, nevertheless, one cannot well have a lien on his own property. A bank having in its possession the property of another, may have a lien on that property, but a bank holding general deposits which belong to a bank, cannot have a lien on these deposits to secure a claim which it has against the debtor of the bank. The right of a bank to pay a debt owed to the bank by a creditor by cancelling a claim of that debtor against the bank is really a set-off, arising from the relations of the bank to its depositor or customer or any other party dealing with the bank. This right is independent of the statute of set-off, because it is an equitable right of set-off arising from the mutual dealings or transactions of the bank and the other party. Since it has been the custom for banks to deal with depositors and customers with the understanding and on the faith and expectation that a set-off shall be allowed, and since such dealings are generally understood to be part of the business of banking, courts of equity may the more readily find an implied contract when a bank is involved, than in other cases. After the implied contract is found, set-off will be allowed.[57]

A debtor to the bank, whose debt was not due at time of making assignment, has been held to have the authority to waive the time of credit which was secured for his own benefit, and pay his debt at once in money or by way of set-off of the amount due him from the estate.[58] When the courts say the debtor to the bank has

[55] Gibbons *v.* Hecox, 105 Mich. 509, 513, 63 N. W. 519 (1895).

[56] *Ex parte* John S. Foster, 2 Story (U. S.) 131 (1842).

[57] See Bank cases of set-off, notes 2 and 3, *supra.*

[58] Oatman *v.* Bank, 77 Wis. 501, 46 N. W. 881 (1890); Mechanics Bank *v.* Stone, 115 Mich. 648, 651, 74 N. W. 204 (1898); Thompson *v.* Union Trust Co., 130 Mich. 508, 512, 90 N. W. 294 (1902).

a right to waive the time of payment, they must mean we believe that the debtor has a right by express or implied contract to credit on his debt any advances he makes or any obligations which may run from time to time from the insolvent in favor of such debtor. If an individual can thus set off against an insolvent bank, of course, a bank can set off against an insolvent individual. The bank can set off an account or a certificate of deposit or other future indebtedness. The courts in the United States are almost all in accord with allowing a set-off under the circumstances mentioned above. However, if an insolvent bank owes an individual an amount payable in the future, a great many authorities hold that the individual must pay whatever he owes to the insolvent bank, and cannot set off the indebtedness due from the bank in the future.[59] Putting the shoe on the other foot, many authorities hold that a bank holding an unmatured obligation of an insolvent cannot set this off against a present debt of the bank, whether he be a depositor or other party.[60] The cases thus holding, follow the New York case of *Fera* v. *Wickham*, and most of them give the reasons which were given in that New York case. It has been held that even though action on the note unmatured at time of insolvency declared, was not commenced until it had matured and become due, that did not make any difference.[61] In spite of a long line of cases to the contrary, we believe natural equity demands that an express or implied contract to set-off should be carried out by the courts of equity when insolvency takes place. That at the time when the estate of the insolvent is being distributed and conflicting claims between the insolvent and other parties are finally settled up, the claims on one side and the other side should be balanced, and only the balance become payable one to the other. This is so if the result of insolvency declared and receiver appointed is to put it out of the power of the insolvent to pay the debt in the future. This results in bankruptcy proceedings, and it generally results when a receiver is appointed of an insolvent to wind up his affairs. It is for the court to determine of course, in each case, whether or not it is no longer possible for the insolvent to pay his debts, and therefore, whether a breach of a contract to pay in the future has

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[59] See note 2, *supra*.

[60] See 2 MORSE ON BANKING, § 134 (2 b) and cases cited.

[61] Fera *v.* Wickham, note 1, *supra*.

taken place. If this has taken place it is impossible to settle claims without balancing obligations which exist *in presenti*, even though payable *in futuro*, and it makes no difference whether these obligations are due to or from the insolvent, provided we can determine with reasonable certainty and without undue delay the present value of these conflicting obligations.

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